A New Standard for Liquidated Damage Provisions Under the Uniform Commercial Code?
Equitable Lumber Corp. v. IPA Land Development Corp.

I. INTRODUCTION

Though the extent to which a liquidated damages clause can be enforced by an aggrieved party in a breach of contract action is hardly a novel question,[1] a new dimension was added to enforceability determinations with the adoption of the Uniform Commercial Code [hereinafter referred to as Code]. While common-law determinations focused on whether the liquidated damages clause was a reasonable anticipation of the aggrieved party's harm, section 2-718(1) specifically added as a new, alternative focal point the amount of "actual" damages sustained by the aggrieved party. This section states:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated *or actual* harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[2]

Thus, section 2-718(1) also retained the common-law focus on "anticipated" damages as a time point by which to measure enforceability, as well as reiterating the long extant rule that penalty-for-breach provisions will not be allowed to masquerade as liquidated damages clauses.

The practical meaning of section 2-718(1) has seldom been litigated since the Code's widespread adoption in the 1960's.[3] The New York Court of Appeals, in *Equitable Lumber Corp. v. IPA Land Development Corp.*,[4] had an opportunity to undertake a detailed analysis of section 2-718(1). This case involved a liquidated damages clause that provided for recovery of attorney's fees in case of default

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1. *See, e.g.*, Kemble v. Farren, 6 Bing. 141, 130 Eng. Rep. 1234 (1829).

2. UCC § 2-718(1) (emphasis added). No local variations of § 2-718(1) exist.

3. Research for this article has indicated that section 2-718(1) and its technical construction and operation had not received a detailed analysis in a reported decision by any court in any jurisdiction until *Equitable Lumber*. The relatively few courts that have considered the statute have usually cited the section as indicating that a liquidated damages clause must be "reasonable," without delving into the tests as set out in the statute for "reasonability." *See, e.g.*, Northwestern Motor Car v. Pope, 51 Wis. 2d 292, 295, 187 N.W.2d 200, 202 (1971), in which the court stated that "the statute contemplates that a liquidated damages clause may be enforceable if 'reasonable.' . . . It . . . is a question to be determined after trial." Many citator references to § 2-718(1) are merely cross references made to that section from § 2-719, which contains a reference to "the preceding section."

4. 38 N.Y.2d 516, 344 N.E.2d 391, 381 N.Y.S.2d 459 (1976).

by the buyer in a sales contract.[5] Though attorney's fees provisions have traditionally been analyzed by many jurisdictions as a special category of liquidated damages,[6] the New York Court of Appeals, in applying article 2 of the Code, treated an attorney's fee provision like any other liquidated damages provision that might be found in a sales contract. As no direct mention was made of attorney's fees in article 2, the court resorted to the general provisions governing liquidated damages contained in section 2-718(1). Hence, *Equitable Lumber*, as the first case to undertake a detailed analysis of section 2-718(1), has commercial impact beyond the specific area of attorney's fees recoveries.

This Case Comment will examine the addition that section 2-718 (1) was intended to make to the common-law test for the enforceability of liquidated damages provisions. After scrutinizing this section's interpretation by the New York Court of Appeals, it will suggest that no real clarification of the subject of liquidated damages has been effected either by the Code or the court's decision in *Equitable Lumber.*

II. THE EQUITABLE LUMBER CASE

Equitable Lumber Corporation (plaintiff), a lumber and building materials supplier located in Brooklyn, New York, entered into a written sales agreement in September, 1973, with I.P.A. Land Development Corporation (defendant), a builder and land developer engaged in the construction of several houses.[7] The builder-corporation's president and manager, a member of the New York Bar, executed the writing for I.P.A. In October 1973, one month after the writing's execution, the plaintiff-seller delivered, pursuant to the builder's orders, lumber and building materials that the defendant-buyer used in the construction of one of its buildings. Subsequently, defendant refused to pay for the materials, closed its offices, and its president moved to Spain.[8]

The sales agreement between these two commercial concerns contained the following liquidated damages provision:

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5. According to the court, "research has revealed that the precise question raised here has not been considered by any other jurisdiction." 38 N.Y.2d at 518 n.1, 344 N.E.2d at 393 n.1, 381 N.Y.S.2d at 461 n.1.

6. *See, e.g.*, McIntire v. Cogley, 37 Iowa 676 (1873). For a brief history of the subject of attorney's fees recoveries, see Mayer and Stix, *The Prevailing Party Should Recover Counsel Fees*, 8 AKRON L. REV. 426 (1975).

7. The facts of *Equitable Lumber* are set out at 38 N.Y.2d at 518, 344 N.E.2d at 393, 381 N.Y.S.2d at 461.

8. The reported opinion stated that the defendant's president "fled" to Spain. 38 N.Y.2d at 523, 344 N.E.2d at 396, 381 N.Y.S.2d at 464. However, counsel for defendant stated in a letter to this author that the president simply wound up the corporation's affairs as best he could before he took a "long-planned departure for residence in Spain." However, the defendant continued to be the corporation *per se.*

> If the Buyer breaches this contract and the enforcement thereof, or any provision thereof, or the collection of any monies due thereunder is turned over to an attorney, the Buyer herein agrees to pay, in addition to all of Seller's expenses, a reasonable counsel fee; and in the event the matter turned over is the collection of monies, such reasonable counsel fee is hereby agreed to be *thirty (30%) per cent.*[9]

Following the defendant's default, the plaintiff did turn the collection of the defendant's account over to an attorney. An action was brought in the Supreme Court of Kings County for the recovery of the purchase price of the materials and the "reasonable counsel fee" stipulated in the contract. The answer of the defendant was in effect a general denial, which contained the apparently spurious defense that a portion of the goods were not of merchantable quality.[10]

The trial court held that the defendant's answer was a sham and frivolous, insofar as it denied owing $3,936.42 for the merchandise it claimed to be nonmerchantable. But the trial court did grant defendant's request for a hearing to determine the "reasonable" value of the legal services rendered by the plaintiff's attorney. The trial court subsequently ruled that it would substitute its own judgment on the amount of a reasonable attorney's fee, rather than adhere to the parties' stipulation that thirty percent of the amount recovered was "reasonable." The result was that the court limited the attorney's fee recovery to $450.00, after finding that a maximum of ten hours was required to handle the matter properly. Though it was not specifically reported, apparently the trial court determined that a fee of $45.00 per hour for such collection proceedings was a "reasonable" attorney's fee.[11]

The Appellate Division, Second Department, modified the trial court's judgment and increased the attorney's fees recovery from $450.00 to $750.00.[12] The court did not state in its memorandum opinion whether the $750.00 figure was reached by finding that ten hours was the time that the plaintiff's attorney should have expended on this collection matter but that $75.00 per hour was simply a more "reasonable" attorney's fee rate, or whether the court was awarding a lump sum that approximated twenty percent of the purchase price recovery.[13]

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9. Italics were contained in the original contract. The liquidated damages clause in question was printed on the reverse side of the contract order forms of seller. 38 N.Y.2d at 519, 344 N.E.2d at 393, 381 N.Y.S.2d at 461.

10. *Id.*

11. Had the 30% provision been enforced, the recovery for attorney's fees would have been $1,180.93. The $450.00 was a recovery of only 11.4% of the purchase price.

12. 45 App. Div. 2d 1003, 358 N.Y.S.2d 672 (1974). The $750.00 was a recovery of 19.1% of the purchase price.

13. In New York most of the previous litigation over the enforcement of attorney's fees was in the context of provisions contained in promissory notes. In general, 20% has been seen by New York courts as being a "reasonable" attorney's fee recovery. *See, e.g.*, General

The New York Court of Appeals based its opinion on article 2 of the Code and its provisions for liquidated damages, though neither party argued the provisions of article 2. The parties' briefs dealt with the prior cases of attorney's fees provisions in promissory notes. Thus, the court apparently struck out on its own when it based its decision on article 2. Citing the allowance for substitute or additional remedies in section 2-719(1),[14] the court of appeals upheld the parties' latitude to provide for recovery of reasonable attorney's fees. The court also recognized that such latitude was circumscribed by section 2-302 (pertaining to unconscionability)[15] and section 2-718(1) (governing liquidated damages clauses).[16] Section 2-302 was found to be inapplicable to the facts of this case, apparently because the court was unwilling to extend that section's avoidance powers to a contract between two commercial parties of supposedly equal bargaining power.[17]

In contrast, the court found the limits of section 2-718(1) to be controlling for this sales contract. The court rejected the trial court's

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Lumber Corp. v. Landa, 13 App. Div. 2d 804, 216 N.Y.S.2d 33 (1961). It may be that the Appellate Division awarded the $750.00 as a close approximation of 20% of the purchase price recovery, though this is mere speculation.

14. "[T]he agreements may provide for remedies in addition or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article . . . ." U.C.C. § 2-719(1)(a).

15. If the Court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

U.C.C. § 2-302(1).

16. *See* text accompanying note 2 *supra* for full text of U.C.C. § 2-718(1).

17. When the court refused to extend the contract avoidance powers of U.C.C. § 2-302 beyond the context of the individual consumer, it emphasized that the defendant could not "assume the posture of a commercially illiterate consumer beguiled in a grossly unfair bargain by a deceptive vendor or finance company." 38 N.Y.2d at 523, 344 N.E.2d at 396, 381 N.Y.S.2d at 464. The court then cited the familiar case of Jones v. Star Credit Corp., 59 Misc. 2d 119, 281 N.Y.S.2d 964 (Sup. Ct. 1969)—in which the consumer would otherwise have paid over $1,200 for a $300 freezer had the court not found the contract unconscionable—as "classic" case of unconscionability.

This refusal to extend § 2-302 apparently follows the general trend of nonapplication of "unconscionability" between commercial parties. One commentator has characterized this trend as a "solid wall building to separate its use in consumer deals from those involving merchants. . . . Section 2-302 has gotten exactly nowhere as a sword to sever deals between businesses." Duesenberg, Practitioner's View of Contract Unconscionability (U.C.C. § 2-302), 8 U.C.C. L.J. 237, 241 (1976).

Though the court in *Equitable Lumber* did not directly apply § 2-302, the result of applying "unconscionability" under that section would have been very similar if not identical to the result that the court did reach by applying § 2-718(1). Under § 2-302 a contract clause may be limited or voided by a court; under § 2-718(1), a contract clause for liquidated damages is also limitable or voidable. In the former, the catch-word is "unconscionability;" in the latter, the catch-word is "unreasonability." These two words are but different sides of the same coin, their difference lying only in emphasis rather than significant substance. The result is similar when a court invokes either. But if a court is wary of intrusion into the contractual relationship of two commercially equal bargaining parties under § 2-302, it should be equally wary of intrusion under the powers of § 2-718(1). If a court is to uphold the Anglo-American heritage of contractual freedom for commercial parties, then intrusion into those parties' affairs should be strictly scrutinized, no matter under which specific label the court may proceed.

determination that ten hours was required to handle this matter properly, stating that because the attorney could be expected to bill his client on a contingent fee basis, a time-required analysis was incorrect.[18] Rather, the court stated that an analysis of the harm suffered—either under the "anticipated" or the "actual" damages tests—was the proper focus.[19] The court then remanded the case to the trial court for further factual determinations, suggesting that the normal contingent fee charged by attorneys in the collection context would be the standard by which "reasonability" would be determined, and that the trial court should so determine this "normal" contingent fee.[20]

III. NON-CODE LIQUIDATED DAMAGES TREATMENT

A. *Treatment of Attorney's Fees Provisions*

The history of the enforceability of attorney's fees stipulations has been a varied one. Some jurisdictions have prohibited the enforcement of such clauses because of public policies discouraging unnecessary litigation and prohibiting penalties for contract defaults.[21] Ohio courts, for example, hold that stipulations for the payments of costs and attorney's fees in promissory notes are contrary to public policy and void.[22] New York courts, in contrast, have permitted enforcement of such provisions for at least half a century. The 1925 case of *Commercial Investment Trust v. Eskew*,[23] though addressing itself to the immediate area of promissory note provisions, dismissed the claim that attorney's fees clauses encouraged litigation and were therefore contrary to public policy. The court added that "[n]either can [a provision for attorney's fees] be regarded fairly as a penalty or forfeiture. . . . But if it is to be held a penalty, it is the defaulting party who penalizes himself by his failure to fulfill his primary agreement."[24]

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18. 38 N.Y.2d at 522, 344 N.E.2d at 397, 381 N.Y.S.2d at 465.

19. *Id.*

20. *Id.* Interestingly, since the corporate defendant had no realizable assets, the case was never pursued further after the court of appeals' opinion. The attorney for the plaintiff stated that the litigation was pressed through the appellate level in order to establish the fact that attorney's fees could be a legitimate item for liquidation in a sales contract. Though he was successful in this aspect, as will be seen later, the *Equitable Lumber* case does not throw open the floodgates for potential plaintiffs to recover attorney's fees from defendants without the necessity of demonstrating to the court the reasonableness of those fees.

21. *See, e.g.*, Kittermaster v. Brossard, 105 Mich. 219, 63 N.W.75 (1895). Other jurisdictions prohibiting such clauses are, *e.g.*, Nebraska, North Carolina, and West Virginia.

22. Miller v. Kyle, 85 Ohio St. 186, 97 N.E. 372 (1911); State *ex rel* Fund Comm'rs v. Taylor, 10 Ohio 378 (1841). Ohio seems to be in the minority of jurisdictions in prohibiting provisions for the recovery of attorney's fees. *See* note 21 *supra*. Most jurisdictions do permit such provisions to be enforced, usually with the stipulation that they be "reasonable." *See* 17 AM. JUR. 2D. *Contracts* § 164 (1964) and cases collected therein.

23. 126 Misc. 114, 117, 212 N.Y.S. 718, 721 (Sup. Ct. 1925).

24. *Id.* at 116-17 n.16, 212 N.Y.S. at 720-21 n.16.

The courts of New York thus have a history of allowing attorneys' fees recoveries. Throughout this history the courts have made enforceability turn on reasonableness: "The fundamental question posed to the New York courts is what constitutes a 'reasonable' attorney's fee."[25] But "reasonable" is also the standard that New York courts have used in general to determine the enforceability of all types of liquidated damages provisions. In this respect, New York courts have treated attorney's fees provisions little differently than other liquidated damages provisions. *Equitable Lumber* made no particular point of the fact that it was an attorney's fee recovery that was being litigated; the court at the outset simply proceeded to discuss and apply section 2-718(1). Even in the one short paragraph that mentioned promissory note provisions for attorney's fees, the court succinctly stated that "[c]ourts dealing with such provisions have generally examined the reasonableness of the fee in deciding whether they should be enforced . . . ."[26]

However, attorney's fees are not indistinguishable from other liquidated damages provisions. The "injury" resulting to the aggrieved party by reason of having to pay attorney's fees is at least in partial control of that aggrieved party. Presumably, he can shop around in the legal marketplace for less expensive services; or, knowing that the defendant has agreed to indemnify him, he may seek the most expensive legal help available. Unlike some losses resulting from breach over which the aggrieved party may have little control, attorney's fees can be manipulated. The court in *Equitable Lumber* was aware of this when it indicated that the prevailing fees in the local legal market would be a standard by which to measure reasonability. But the court did not treat the effect of the Code on liquidated damages provisions for attorney's fees as being substantially different from other damages provisions. Thus, the *Equitable Lumber* opinion, as the first since the Code's promulgation to undertake an analysis of section 2-718(1), should therefore not be limited to the specific subject of attorney's fees.

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25. *Id.* at 117, 212 N.Y.S. at 721.

26. 38 N.Y.2d at 522, 344 N.E.2d at 396, 381 N.Y.S.2d at 463. Since the *Equitable Lumber* decision in January 1976, two lower New York courts have had occasion to consider liquidated damages provisions for attorney's fees. In a promissory note context, the appellate court stated that "the provision for attorney's fees in the amount of 20% of any balance due should be examined as to reasonableness." Claire Provision Co. v. Medwed Food Prods. Corp., 52 App. Div. 2d 797, 797, 383 N.Y.S.2d 354, 355 (1976).

In a real estate lease context, the court stated that "[t]he award of attorney's fees to the plaintiffs, pursuant to a lease provision, has been deleted and the case remanded for hearing on the issue of reasonableness." Tuttle v. Juanis, 387 N.Y.S.2d 167, 168 (App. Div. 1976).

In both these cases, the courts cited the *Equitable Lumber* opinion, ostensibly an article 2 case under the Code, as authority for remanding the cases for reasonableness hearings on attorney's fees. *Equitable Lumber* may thus be having the effect in New York of casting stricter scrutiny on all attorney's fees provisions contained in all types of commercial contracts.

B. *Treatment of Liquidated Damages Provisions Prior to the Code*

The concept of liquidated damages is superficially a relatively simple one—that the parties to a contract stipulate as part of their bargain the amount of damages to be paid to the aggrieved party in event of default. But courts have historically struggled with such provisions.[27] The area of liquidated damages clauses is one of the few in which a court will intervene in a commercial contractual relationship to relieve one of the parties from his purportedly improvident bargain. Courts have justified such interventions with varied rationales.

Though a few courts have used "unconscionability" as a mode of analyzing whether to enforce a liquidated damages provision, most courts have begun by saying that the stipulated sum must be found to be "reasonable."[28] The most often-used test of reasonableness is the proposition that a court will enforce the sum stipulated for damages only if the parties could have fairly anticipated such damages at the time of contracting.[29] While this "anticipated damages test" would be simple enough if faithfully followed, courts cannot easily decide (if at all) what constituted a reasonable anticipation of damages at a prior point in time without examining the actual results at the time of the litigation.[30] This basic fact has generated much confusion—confusion which persists even with the advent of section 2-718(1). At which point in time is the "reasonability" of a liquidated damages clause to be determined? Is it the time of contracting, with reference solely to the then "anticipated" damages, or the time of trial, with reference to the "actual" damages sustained? And what, if any, interrelationship should exist between these two time points in that reasonability determination? Such questions were never clearly answered by the pre-Code case law, nor, as will be seen, were they answered by section 2-718(1).

As stated, both pre-Code case law and contemporary contracts cases not covered by the Code most frequently use a test that

27. *See, e.g.*, Ward v. Hudson River Bldg. Co., 125 N.Y. 230, 235, 26 N.E. 256, 257 (1891), in which it was stated that any formulation of a general rule relating to the enforcement of provisions for liquidated damages was difficult, if not impossible.

28. The practical difference between the two tests is minimal. A court will invalidate a contract clause through "unconscionability" in much the same manner as "unreasonability." The difference, if any, is probably on emphasis rather than substance. *See* note 17 *supra.*

29. *See, e.g.*, Downtown Harvard Lunch Club v. Rasco, Inc., 201 Misc. 1087, 107 N.Y.S.2d 918 (Sup. Ct. 1951). The RESTATEMENT (SECOND) OF CONTRACTS § 339 (2) (Tent. Draft No. 17, March 1977) provides that "[a]n amount of money fixed as damages is liquidated damages and not a penalty if it is reasonable in light of the anticipated or actual harm caused by the breach and the difficulties of proof of loss."

30. In assessing whether the stipulated sum for damages was reasonable at the time of contract formation, courts are virtually forced to look at what happened subsequently to determine what the parties' intentions were at the time of contract formation. "[T]he court cannot help but be influenced by its knowledge of subsequent events." 5 A. CORBIN, CONTRACTS § 1063 (1964).

theoretically focuses solely upon the time of contract formation—whether the damages stipulated in the contract by the parties constitute a fair and reasonable pre-estimate of the damages. Even as late as 1974, the New York Court of Appeals, in a non-Code case could state:

> Where . . . damages flowing from a breach are difficult to ascertain, a provision fixing the damages in advance will be upheld if the amount [stipulated in the contract] is a reasonable measure of the anticipated probable harm. . . . If on the other hand, the amount fixed is grossly disproportionate to the *anticipated* probable harm or if there were no anticipatable harm, the provision will not be enforced.[31]

This opinion is only the most recent of a long line[32] of New York cases that "speak as though with one voice that the reasonableness of the sum fixed in the agreement is to be determined as of the time of the making of the agreement and not as of the time of the breach."[33] Thus, under the traditional rule of New York and other courts, disparity or unreasonableness is not to be ascertained by the loss that actually ensues, but rather by the situation as it existed at the time of making the contract.

But even as the New York cases speak this standard "with one voice," the same courts usually have also either explicitly stated or implicitly recognized that a gross variance between the stipulated sum and the *actual* damages sustained will preclude enforceability, *even if* a court could find that the stipulated sum was a reasonable *anticipation* of the aggrieved party's damages.[34] *Equitable Lumber* recognized this principle when it stated that New York courts have "refused to enforce a liquidated damages provision which fixed damages grossly disproportionate to the harm actually sustained, or likely to be sustained by the non-breaching party."[35]

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31. City of Rye v. Pub. Serv. Mut. Ins. Co., 34 N.Y.2d 470, 473, 315 N.E.2d 458, 459, 358 N.Y.S.2d 391, 393 (1974) (emphasis added).

32. *See, e.g.*, Seidlitz v. Auerbach, 230 N.Y. 167, 172, 129 N.E. 461, 463 (1920); Dunn v. Morgenthau, 73 App. Div. 147 (1902), *aff'd mem*, 175 N.Y. 518, 67 N.E. 1081 (1903); Downtown Harvard Lunch Club v. Rasco, Inc., 201 Misc. 1087, 107 N.E.S.2d 918 (Sup. Ct. 1951); 14 N.Y. JUR. *Damages* § 162 (1969).

33. Crowley, *New York Law of Damages Revisited*, 4 NEW YORK CONTINUING LEGAL EDUCATION 59, 63 (1966).

34. *See, e.g.*, Cotheal v. Talmadge, 9 N.Y. 551, 554 (1854), which held that a liquidated damages clause will be enforced "unless it be so grossly disproportionate to the actual injury that a man would start at the bare mention of it." Indeed, this language of "start at the bare mention" seems to be more of a classic formulation of unconscionability, which may indicate the lack of precise distinction between the two concepts of unconscionability and unreasonability. *See* note 17 *supra*.

35. 38 N.Y.2d at 522, 344 N.E.2d at 395-96, 381 N.Y.S.2d at 463. The court quoted from the case of Wirth & Hamid Fair Booking v. Wirth, 265 N.Y. 214, 223, 192 N.E. 297, 301 (1934), which stated that "liquidated damages constitute the compensation which the parties have agreed must be paid in satisfaction of the loss, or injury which will follow from a breach of contract. They must bear reasonable proportion to the actual loss."

This condition, placed on the finding of reasonability under an anticipated damages analysis, can be analyzed in two ways. The first analysis proceeds on the basis of unconscionability as that concept has been traditionally defined. But the court in *Equitable Lumber* explicitly refused to apply the unconscionability avoidance powers of section 2-302.[36]

The second possible analysis is that the time honored common-law test is not purely one of whether the stipulated sum is reasonable as *anticipated* damages, but rather it is a "hybrid" test of "reasonable-as-anticipated, but not to disproportionately exceed *actual* damages." Confusion has arisen from this proposition on the effect that "actual" damages should have on the reasonability determination, as courts—though cognizant of the essence of this "hybrid" test's condition—have continued to adhere to the traditional language of "anticipated damages."[37]

What is this hybrid test? Does a *double* reasonability test actually apply—does a plaintiff have to prove both that a stipulated damages clause is reasonable at the time of contracting *and* in relation to the losses that actually occurred? Or is the amount of losses actually incurred merely evidence helpful in determining what was reasonable at the time of contracting? Or, simply, if the traditional language is to be strictly applied, need a plaintiff show any actual loss at all? A sampling of the cases suggests that no definitive choice has been made by the courts, as they have used language from which any of the above formulations could be inferred.[38] However lacking in precision the emphasis to be given "actual" damages under the hybrid test, the *Equitable Lumber* opinion reaffirmed the continuing application of the general principle of the hybrid formula to non-Code cases in New York.[39] In essence, the "anticipated" damages test should actually be deemed the "anticipated-actual damages test."

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36. *See* note 17 *supra* and accompanying text.

37. *See, e.g.*, City of Rye v. Pub. Serv. Mut. Ins. Co., 34 N.Y.2d 470, 473, 315 N.E.2d 458, 459, 358 N.Y.S.2d 391, 393 (1974).

38. *See* Wirth & Hamid Fair Booking v. Wirth, 265 N.Y. 214, 223, 192 N.E. 297, 301 (1934) ("Liquidated damages constitute the compensation which the parties have agreed must be paid in satisfaction of the loss or injury which will follow from a breach of contract. They must bear reasonable proportion to the actual loss."); McCann v. Albany, 158 N.Y. 634, 53 N.E. 673 (1899) (a liquidated damages clause was denied enforcement as only nominal damages were sustained by breach); Realworth Props., Inc. v. Bachler, 33 Misc. 2d 39, 45, 223 N.Y.S.2d 910, 916 (Sup. Ct. 1962) (The validity of the liquidated damages clause depends upon the situation as of the date of the agreement and the sum agreed upon as a reasonable estimate of the then probable damage. "But it is also said that the courts, besides considering the factual situation confronting the parties at the time of agreement, will also consider the equity and reasonableness of the result after breach.")

39. 38 N.Y.2d at 522, 344 N.E.2d at 395, 381 N.Y.S.2d at 463. *See* note 35 *supra* and accompanying text.

IV. SECTION 2-718(1) AND THE "ACTUAL" DAMAGES TEST

A. *"Actual" as an Alternative to "Anticipated" Damages*

With the enactment of the Code, a new criterion was explicitly added to the rationale of that unbroken[40] line of New York decisions that perfunctorily held that the validity of a liquidated damages provision is to be determined by its reasonability at the time of contracting. The Code merely made explicitly available what was routinely used: an examination of "actual" damages in determining the enforceability of a liquidated damages clause. Section 2-718(1) did not change the basic goal of determining "reasonability" in order to enforce a liquidated damages provision. Section 2-718(1) purports merely to add another test, another time focus by which reasonability can be determined.[41]

Section 2-718(1) appears to add the alternative of examining the actual damages resulting from a breach as a new route to finding that the stipulated sum of a damages clause is reasonable and thereby enforceable.[42] The key, of course, is the meaning to be given to the phrase, "an amount which is reasonable in light of the anticipated *or actual* harm caused by the breach." The purported promise of section 2-718(1) is that an aggrieved party has two alternative chances for his liquidated damages provision to be upheld, and that the aggrieved party now has "a bit more liberality [than] existed in the cases prior to the Code."[43] The situation apparently contemplated by the Code drafters was that if a liquidated damages sum were to fail one alternative of the section 2-718(1) test it could still be redeemed by meeting reasonability under the other alternative.[44]

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40. *See* Crowley, *supra* note 33, at 63.

41. U.C.C. § 2-718(1) states:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or *actual harm* caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

(Emphasis added).

42. Two other criteria are set out in § 2-718(1) for determining reasonableness: "difficulties of proof of loss" and "inconvenience or non-feasibility of otherwise obtaining an adequate remedy." These two criteria have been characterized as being virtually identical by Professor Crowley. Crowley, *supra* note 33, at 75. Moreover, they seldom have been found to be dispositive of a liquidated damages question. As the court in *Equitable Lumber* did not examine these criteria in its opinion, this Case Comment will not examine the apparent non-use of these two criteria. Moreover, Crowley points out in this context that "the courts will be guided more by the conscionability or unconscionability of the situation rather than by the precise language of the statute." Crowley, *supra* note 33, at 77.

43. 3A UCC REPORTER (BENDER'S) § 14.08.

44. Initially, the first criterion of § 2-718(1), the "anticipated or actual" damages language, is susceptible to differing interpretations of construction. The most easily accepted construction—and the one adopted by the *Equitable Lumber* court—is a disjunctive one: that a liquidated damages clause will be enforceable if the amount stipulated therein is reasonable when analyzed as *either* "anticipated" damages *or* "actual" damages or both.

The less tenable construction, inferring a legislative intent to make the new Code test even

This promise of more "liberality," however, proves to be illusory in the normal commercial sales contract context.

With the addition of actual damage as an *alternative* focal point, a stipulated damages sum can find enforceability even if, as anticipated damages, the sum was unreasonable—or at least this is the theoretical possibility of the disjunctive "or" in section 2-718(1).[45] But expressly treating actual damages as an *alternative* focal point fails to recognize the logical and pragmatic—though ill-defined—influence that actual damages had routinely exercised in prior case law determinations. Properly seen, the addition of "actual" only makes explicitly available to the court what was implicitly used anyway—a *post hoc ergo propter hoc* logic of liquidated damages validation.

In essence, alongside the previous focus on anticipated damages —which implicitly contained the condition that anticipated damages stipulated must bear a general proportionality to the actual losses— is now added an alternative focus simply on actual damages. But the two were already so interrelated that the addition may not signal any affirmative change and may only add more confusion to this previously cloudy area. If a court should state that the stipulated sum is enforceable because it was "reasonable as anticipated damages" has it not taken into account actual damages? Moreover, even if a court should find reasonability of the stipulated sum as anticipated damages and not proceed to the new alternative, the party against whom the stipulated sum is to be enforced would be likely to call the court's attention to actual damages in an attempt to discredit the court's finding of reasonability at the anticipated damages time point. As Professor Crowley has stated, section 2-718(1) "[does] not reduce the confusion surrounding the application of the principle

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more stringent than that imposed by the prior case law, is that the liquidated damages clause will be *void* if the amount stipulated is disproportionate when tested by either one or the other of the two time references. That is, an invalidity in one and only one will invalidate the entire clause, even it would pass muster under the other time reference.

Professor Hawkland notes that

> a stipulation of damages that is reasonably related to the anticipated harm at the time of the stipulation, is not necessarily invalidated because it fails to forecast correctly the damages that were actually suffered. Conversely, even if the stipulation of damages does not reasonably reflect a fair judgment of anticipated harm as of the time of its making, it is validated by events that put it in line with the damages which actually occur.

1 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 171 (1964).

The New York Law Revision Commission, prior to the New York enactment of the Code, did recognize the possibility of a more restrictive interpretation, but opined that the alternative, disjunctive interpretation was preferable. 1 NEW YORK LAW REVISION COMMISSION, 1955 REPORT 581. The *Equitable Lumber* decision followed the Revision Commission in adopting the alternative test, stating, "a liquidated damages provision will be valid if reasonable with respect to *either* (1) the harm which the parties anticipate will result from the breach at the time of contracting, or (2) the actual damages suffered by the non-defaulting party at the time of the breach." 38 N.Y.2d at 521, 344 N.E.2d at 395, 381 N.Y.S.2d at 462.

45. Crowley, *supra* note 33, at 72.

of liquidated damages; rather [it] appear[s] to perpetuate the confusion."[46]

B. *The Interrelation of "Actual" and "Anticipated"*

When anticipated damages were theoretically the sole focal point of the reasonability determination, only three outcomes were possible. As an anticipation of damages, the stipulated sum could be 1) disproportionately excessive ("too high"), 2) approximately correct, or 3) disproportionately low ("too low"). For an examination only of "actual" damages, the same three outcomes are still the only ones possible.

However, these three possible outcomes for each of the two analyses (anticipated or actual) can be interrelated to form nine combinations: *e.g.*, though the stipulated sum may be "too high" when analyzed as anticipated damages, the same sum may be "too low" when analyzed as actual damages. These nine combinations and their logical impact demonstrate—even under the disjunctive analysis section 2-718(1) seems to suggest—why the addition of actual damages only "perpetuates the confusion"[47] and adds very little additional "liberality."[48] Moreover, because the traditional anticipated damages test has always been the hybrid anticipated-actual damages analysis, the addition of "actual" adds little to what was routinely used by the courts anyway and signals no affirmative departure from the common law.

In a combination-by-combination review of the nine possibilities,[49] two obviously nonproblematical situations present themselves immediately. If the stipulated sum is "too high" when examined both as anticipated and actual damages, then the liquidated damages provision is unreasonable and a penalty and cannot be saved under either analysis. And if the stipulated sum is approximately correct when examined both as anticipated and actual damages, then there will be little problem of enforceability.

There is also one other generally nonproblematic combination. Should the court determine that as anticipated damages the stipulated sum is unreasonably low, but that it approximates the actual damages, no problem is raised. The plaintiff, with or without actual damages as a second chance to validate his liquidated damages clause, can complain of no injury if he recovers an amount for the injury he actually did suffer. Having actual damages as an alternative adds little if anything in this situation.

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46. *Id.*

47. *Id.*

48. BENDER'S, *supra* note 43, at § 14.08.

49. These nine combinations have been arranged into a matrix, which depicts the logical

Unfortunately, the other six combinations are not as easily treated. Problems arise when a court could find either that the stipulated damages sum yields different outcomes when examined alternatively as anticipated and actual damages, or that the stipulated sum is clearly "too low" under both analyses. Whenever a court could find, through a literally disjunctive damages analysis, different outcomes of reasonability, the difference itself casts doubt upon the accuracy of either one or both of the purported reasonability findings. A court would be likely to avoid the confusion caused by such different findings by a general "totality of the circumstances" examination of reasonability.[50] The efficacy of this proposition will be seen in the following combination-by-combination scrutiny.

The combination that comes to mind most readily is suggested by the promise of more "liberality" and the notion that the Code drafters desired to give a liquidated damages clause a second chance at validation when they added "actual" to section 2-718(1). In this combination the stipulated sum is unreasonably *large* as anticipated damages, but is reasonable (and therefore enforceable) when examined as actual damages. Literally applying section 2-718(1), a court could in this manner uphold the stipuated sum. But in actual practice, should a court find that even though the stipulated sum is unreasonably large as anticipated damages and it correctly measures the actual injuries suffered, the court may be hard pressed to maintain that the anticipated damages were incorrect in the first instance. If actual injury comes close to what the parties stipulated—*i.e.*, anticipated—in the contract, then did they not do a fair and reasonable job of anticipating? Professor Crowley indicates that

> the implementation of [the criterion of actual] may not give rise to an affirmative departure from common law, for if the actual damages bear a reasonable relationship to the stipulated sum, this may provide a basis for a conclusion by the courts that the parties obviously made a good faith effort to estimate damages in the event of a breach.[51]

Still, a court could literally state that a stipulated damages sum is excessive as anticipated damages but correct as actual damages and therefore enforceable. Corbin commends such a result, stating that even though at the time of contracting the sum stipulated is disproportionate to the likely injury, if actual injury should prove the sum stipulated not to be an unreasonable amount for recovery, then

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determinations a court would make should it arrive at any particular combination of "actual" and "anticipated" damages. This matrix is reproduced at page 452 *infra*.

50. *Cf.* Crowley's suggestion, in the context of the court's likely response to the second and third criteria of § 2-718(1), that the precise language of the statute will probably not be followed, but a general conscionability determination will be made. *See* note 42 *supra*.

51. Crowley, *supra* note 33, at 73.

there should be "no good reason why the court should not enforce the provision in the contract."[52]

In the three combinations in which the stipulated sum is found to be "too low" when analyzed as actual damages, the court may view the liquidated damages provision as a limitation on the plaintiff's remedy—that the parties bargained that the plaintiff would be able to recover only up to the stipulated sum, even if his actual injury were far higher. The Code itself allows such limitations on remedies in section 2-719(1).[53] Any defaulting party could be expected to argue that the "too low" finding for the stipulated sum when compared with actual damages was simply a bargained-for limit on the aggrieved party's recovery. But if a court could be persuaded that such an "underliquidated" provision was unreasonably imposed by the defaulting party at the time of the original contract formation, a finding of "too low" would then be reason for discarding the stipulated sum's limitation.[54] The Official Comments to section 2-718 suggest such a result, stating that "[a]n unreasonably small amount [of liquidated damages] would be subject to being held a penalty and void and might be stricken under the section on unconscionable contracts or clauses." Moreover, the one combination of these three with the greatest disparity—in which the stipulated sum is "too high" as anticipated damages but "too low" as actual damages—may be unlikely to occur. The fact that as actual damages the stipulated sum was found to be too low—in essence, an overwrought limitation of remedy imposed by the defaulting party upon the aggrieved party—makes it unlikely that a court could simultaneously find that the aggrieved party had imposed upon the defaulting party unreasonably large anticipated damages. Abuse of bargaining power usually is worked in only one direction in the stipulation of liquidated damages.

The other two remaining combinations are those in which the stipulated sum is too high as actual damages but might be found to be either approximately correct or too low as anticipated damages. In the former, the "too high" finding as actual damages may cast doubt on whether the parties "correctly" anticipated the damages at time of contracting, in that the stipulated sum may have been intended to be a penalty clause. This situation may mean, however, that the damages that actually ensued simply fell far short of what any reasonable person could have anticipated. Or they may have done a poor job of anticipating—after all, parties seldom make the event of default a major area of their contract negotiations. Whatever the

52. A. CORBIN, *supra* note 30, at § 1063. *But see* note 63 *infra.*

53. The text of § 2-719(1) is set out at note 14 *supra.*

54. *See* note 67 *infra.*

reason, the court may refuse to enforce the clause in this situation, going back to the pre-Code notion that the stipulated sum, even if a reasonable anticipation, must be proportional to the actual damages.[55] The addition of actual makes little difference in this combination.

In the remaining combination—in which the stipulated sum is too high as actual damages but too low as anticipated damages—the great disparity between the two analyses makes this an unlikely situation. The finding of too high as actual damages casts doubt on the parties' intent at fairly anticipating damages. Moreover, even if the damages that actually occurred turned out to be far less than what a reasonable person could anticipate—even when that reasonable person would also say that the stipulated sum was itself less than what could be anticipated—a court may not award the plaintiff recovery in excess of the loss he actually suffered. The pre-Code notion of proportionality to actual injury plays an even more important role for this combination.[56]

The above discussion about the nine possible combinations can be depicted in a matrix, which helps to emphasize the interrelationships between anticipated and actual damages discussed above and lends support to the proposition that little substantive addition was made by the inclusion of actual damages. The matrix below represents the nine different combinations possible when the three outcomes of "too high," "too low," and "approximately correct" are distributed over both anticipated damages and the newly added actual-damages tests.

Logically, under the disjunctive alternatives of section 2-718(1) a court may begin with either anticipated or actual damages in its examination of the stipulated sum. But in accordance with tradition, the assumption is that the court will initially inquire into the stipulated sum's reasonability by using the anticipated damages analysis. Hence, it is placed along the top of the matrix, and is the direction from which the reader should begin his examination. After the stipulated sum is determined to be one of the three possibilities when considered as anticipated damages, then the three possible results of a subsequent examination as actual damages are correlated in each horizontal row of the matrix. The reader will note the interrelationships between the two time foci, and the support that the matrix lends to the proposition that the traditional anticipated-damages test has always been the hybrid anticipated-actual damages test, so that the addition of actual damages adds little to what was routinely used by the courts anyway.

The following syllogism is suggested to the reader to be used

55. *See* note 35 *supra.*

56. *Id.*

in the interpretation of the matrix below: If the sum stipulated in the contract is first examined as *anticipated* damages, and is determined to be (high/correct/low), then when the stipulated sum is subsequently examined as *actual* damages, and under *that* standard to be (high/correct/low), *then* the interrelation between these examinations' results will be as indicated in the corresponding square in the matrix.

	ANTICIPATED DAMAGES		
ACTUAL DAMAGES	TOO HIGH	APPROX. CORRECT	TOO LOW
TOO HIGH	Clause will not be enforced. Non-problematic.	May indicate that it was a penalty clause, or in reality a poor anticipation. Court may not enforce, due to "proportionality-to actual" notion.	Casts doubt on "too low" as anticipated finding. Court may not enforce due to "proportionality to-actual" notion.
APPROX. CORRECT	May literally find enforcement from section 2-718; casts doubt on "too high" finding as anticpated. But *Hadley v. Baxendale* problems.[57]	Clause will be enforced. Non-problematic.	Probably non-problematic. Plaintiff could show no injury, as he recovers his "actual" harm.
TOO LOW	Casts doubts on finding of "too high" as anticipated. Unlikely to occur. Plaintiff would probably be limited to his bargain unless unconscionability used to increase recovery.	Plaintiff would probably be limited to his bargain, unless a finding of unconscionability is used to increase his recovery.[58]	

The above matrix is an exercise in logic, based on the proposition that courts will not decide, or cannot decide, reasonability in a vacuum and that they will be guided by the totality of circumstances in determining reasonability. Such determinations will include an examination of both the anticipation of the parties and the actual harm that the aggrieved party suffered. The addition of actual damages adds very little to the traditional "hybrid" test[59] that the courts have previously used. Thus, the likely result will be that the two time foci will be molded by application—as they were in *Equitable Lumber*, and in actuality always have been in the "anticipated-actual" test—into one general "totality of circumstances" examination of reasonability.

C. *The Definitional Problem of "Actual"*

This use of general reasonability may be further required by the definitional problems inherent in the use of "actual." Does this ad-

57. The discussion of the *Hadley v. Baxendale* problems in the definition of "actual" follows in section IV.C *infra*.

58. *See* note 67 *infra*.

59. See text accompanying note 37 *supra*.

jective mean *all* damages which flowed from the breach, or only those damages that a court of law would hold compensable? The familiar rule of *Hadley v. Baxendale*,[60] codified at least in part by Code section 2-715(2),[61] that a defaulting party shall not be made to pay for the limitless entirety of the injury which ensues from a contract breach has direct application to the point in hand.[62] In the left center square of the matrix, a stipulated sum for damages disproportionately high as anticipated damages should not find validity through the section 2-718(1) "actual" test in contravention of *Hadley*, merely because the damages resulting from the breach—consequential damages for which the defendant would not otherwise be liable—happen to approximate the stipulated damages in the contract.[63] The aggrieved party should not recover the uncontemplated[64] totality of his losses because what was really a penalty clause turns out to approximate the totality of the losses that party did suffer.

Thus, "actual" must be defined in accordance with the venerated rule of *Hadley*—and that defining process will inevitably bring in notions of commercial reasonability and limitations on consequential damages. Indeed, though in light of *Hadley* the statute could be reconstructed by replacing "actual" with a phrase such as "commercially compensable," only circularity would be added, as the goal is to determine what is "compensable" in the first place. Therefore, the addition of "actual" of section 2-718(1) cannot effect its purported promise of more "liberality" unless *Hadley* is abandoned.

V. EQUITABLE LUMBER'S FORMULATION

The court's initial focus in *Equitable Lumber* was on the alternative disjunctive tests of section 2-718(1). The court began its formulation with a relatively literal adherence to the alternative language

60. 9 Ex. 341, 156 Eng. Rep 145 (1854).

61. "Consequential damages resulting from seller's breach include (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which would not reasonably be prevented by cover or otherwise; and (b) injury to person or property proximately resulting from any breach or warranty."
U.C.C. § 2-715(2).

62. For a discussion of the rule of *Hadley* in the modern commercial setting, see 37 OHIO ST. L.J. 153 (1976).

63. Thus, Corbin's argument that there should be "no good reason" why a court should not enforce the liquidated damages clause in this particular situation fails in light of *Hadley*. While it is true that the actual events that occur later may validate an anticipated damages clause that seems patently unreasonable when taken at time of contracting, the limits of *Hadley* do give a good reason why a court should inquire further into the total of "actual" damages to see if they are fully compensable.

64. The "second" rule of *Hadley* is that the proper test for calculating the amount of damages is an inquiry into what should have been foreseen by the defaulter at the time of contract formation. Hence, if the defaulting party did contemplate that the aggrieved party would suffer the "actual" damages he suffered as a result of the defaulter's breach, then these damages will be compensable. For a further discussion of this second rule of *Hadley*, see 37 OHIO ST. L.J. 153, 156-57 (1976).

of the statute. It ruled that the trial court should determine what the plaintiff would have paid for attorney's fees had it voluntarily sought legal services on the open market without the expectation of recovery for those attorney's fees from defendant. The trial court should then compare this prevailing open-market price with the sum stipulated in the contract, analyzed as either damages anticipated at the time of contracting, or actually-suffered damages. If the parties had accurately anticipated what the prevailing legal services market would charge, then the stipulated provision would be upheld. Alternatively, if the actual fee arrangement between the plaintiff and its attorney was in line with the court-determined prevailing legal market, then the stipulated provision would also be upheld.

But the court of appeals, after remitting to the trial court the examination of the thirty percent attorney's fee provision under this alternative anticipated-or-actual damages analysis, went on to state its controlling test for enforceability—in a relatively confusing manner.

> Even if the 30% did correspond to the actual arrangement between plaintiff and its attorney, the court on remand should determine whether the amount stipulated was unreasonably large or grossly disproportionate to the damages which the plaintiff was likely to suffer from breach in the event it did not rely on respondent's agreement to pay its attorney's fees. If the amount is found to be unreasonably large, then the provision is void as a penalty.[65]

What the court's language does, notwithstanding its stated desire to give efficacy to the alternative examination contemplated by section 2-718(1),[66] is to effectively substitute "and" in place of the "or" between "anticipated or actual" as found in section 2-718(1), with the result of this conjunction being a commingling of the two tests into a general reasonability determination. Such a method of determination leaves in serious question whether a liquidated damages provision could ever be enforced if it were to fail one alternative of the section 2-718(1) test while passing the other alternative—a situation apparently contemplated by the Code drafters when they added actual damages alongside the common law's anticipated damages.[67] Moreover, what the court apparently has done is to

But a conflict exists between *Hadley*'s two rules in the context of liquidated damages. The argument should not be persuasive that a liquidated damages clause that is unreasonable should still be given efficacy because the party against whom it is directed "contemplated" those damages by reason of the clause's inclusion. When a liquidated damages provision is itself under scrutiny, the clause should not be taken to indicate its own reasonability by having been included in the contract; such reasoning only begs the question.

65. 38 N.Y.2d at 524, 344 N.E.2d at 397, 381 N.Y.S.2d at 465.

66. "Thus, a liquidated damages provision will be valid if reasonable with respect to *either* (1) the harm which the parties anticipated will result from the breach at the time of contracting or (2) the actual damages suffered by the nondefaulting party at the time of breach." 38 N.Y.2d at 521, 344 N.E.2d at 395, 381 N.Y.S.2d at 463.

67. Another possible danger with a general "totality of circumstances" reasonability determination is that a court, may struggle too hard to give efficacy to the *second* sentence

vitiate a primary *raison d'etre* for liquidated damages clauses: avoidance of the expense and difficulty of protracted court resolution of contract damages.

Another question the court's above language raises is the effect of a provision for damages being declared "void as a penalty." If the court determines that the liquidated damages provision cannot be enforced as it stands, does this mean that *no* recovery for the injury contemplated by the penal provision will be allowed? Such a result, if the case, would itself be a penalty against the party in whose benefit the original provision was to have run. The policy of the Code seems to be that the unreasonable liquidated damages provision ought to be "void as a penalty" only to the extent that it is unreasonable, and not be limited to a Draconian all-or-nothing dichtomy. Section 2-302, pertaining to unconscionability, suggests this result by its

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of U.C.C. § 2-718(1), as the New York Court of Appeals apparently did in the *Equitable Lumber* decision. This sentence voids unreasonably large stipulated damages clauses as penalties. A court might use this sentence to circumvent the apparent legislative intent to give a "bit more liberality" to enforcement of liquidated damages clauses.

Indeed, the second sentence of § 2-718(1) is entirely superfluous. As the first sentence dictates that liquidated damages clauses will be enforceable "*only* at an amount which is reasonable . . . ." (emphasis added), the addition of the second sentence that "[u]nreasonably large damages are void as a penalty" does not seem to add anything. Yet it provides substance from which too much may be inferred.

As Professor Nordstrom depicted it, the second sentence was added by the Code drafters "with a burst of enthusiasm for the task before them." R. NORDSTROM, LAW OF SALES § 154 (1970). Logically, if the first sentence provides for enforcement of stipulated damages *only* at an amount which is reasonable, then those stipulated sums which are *un*reasonable are excluded from enforcement. The danger is that a court may infer that the Code desires a very strict policy toward—if not an initial presumption against—the enforceability of liquidated damages clauses. The reasoning might proceed that as the legislature said the same thing positively and negatively in back-to-back sentences they must have meant something, for the legislature is not wont to waste words.

Moreover, the second sentence is incomplete: while the first sentence of § 2-718(1) provides for the only situation where a damages clause may be enforced—when the stipulated sum is reasonable—the second sentence only prohibits unreasonably *large* liquidated damages provisions. The logical question is then: what happens to unreasonably *small* provisions for damages? Professor Nordstrom suggests that the "Comments attempt to salvage the situation by suggesting that the section on unconscionable contracts might be used to strike the underliquidated damage clause." *Id.*

Equitable Lumber evinced the strength that the New York Court of Appeals felt must be given the second sentence of § 2-718(1). In its statement that although the actual harm test would be satisfied had plaintiff actually entered into a 30% contingent fee arrangement, the court said, "it is then necessary, pursuant to the second sentence, . . . to determine whether the liquidated damages provision is so unreasonably large as to be void as a penalty." 38 N.Y.2d at 524, 344 N.E.2d at 397, 381 N.Y.S.2d at 465. But reasonability should have been established by the standard of the first sentences of § 2-718(1), which as stated, allows such provisions to be enforced "*only* at an amount which is reasonable." (emphasis added).

Furthermore, the limits on damages recovery articulated by the rule of *Hadley v. Baxendale* should serve to prevent any manipulation of the actual damage that the court seems to wish to guard against by reapplying the reasonability test from the second sentence after such a test supposedly had already been applied from the first sentence. ("While plaintiff may enter into any fee arrangement it wishes with counsel, it should not be permitted to manipulate the actual damage incurred by burdening the defendant with an exorbitant fee arrangement." 38 N.Y.2d at 524, 344 N.E.2d at 397, 381 N.Y.S.2d at 465.) Hence, the presence of the second sentence can lead the court into a double testing of reasonability—a doubling which could effectively negate any legislative intent to achieve a "bit more liberality." One reasonability test is logically sufficient.

language that a court "may so limit . . . any unconscionable clause as to avoid any unconscionable result." This policy should be read into the language of the court in *Equitable Lumber* and the effects to be given in the future to section 2-718(1).

VI. CONCLUSION

Despite the promise of a "bit more liberality" upon the addition of section 2-718(1) to the Code, when the pragmatic application of this section to the enforceability of liquidated damages provisions is analyzed, little additional liberality and clarity have been realized. *Equitable Lumber*, in its attempt to deal with the literal words of section 2-718(1) ended up with a general reasonability determination based on the entirety of the commercial situation. While such a general examination may be more ingenuous than the traditional anticipated damages standard, such an examination can vitiate the one major advantage of liquidated damages clauses—specifically, the avoidance of the time and expense of a protracted presentation of evidence to establish the total commercial situation. As long as the statute remains in its present form, courts will inevitably be tempted to retreat to general reasonability determinations after wrestling with the literal language of the statute. Perhaps the statute should literally be amended to substitute "and" in place of "or" between section 2-718(1)'s alternatives. At least the statute would be more ingenuous in that form. But the caveat that should also appear with any such amendment, as well as being commercially desirable advice for courts dealing with the present statute, is that an unnecessarily strict degree of scrutiny should not be applied to liquidated damages clauses. If their effectiveness is not to be diminished to the point of virtual uselessness in liquidating the damages to be recovered in the event of breach, then courts should allow the same degree of contractual freedom between commercial parties under section 2-718(1) as they have under section 2-302.[68] The Code drafters desired more liberality when they promulgated section 2-718(1); the courts should allow commercial parties to take advantage of it.

Geoffry V. Case

68. *See* note 17 *supra.*